

Russian Mutual Funds: A Growing Asset Class

Mutual funds are making inroads into the Russian market, thanks to a new law on investments finalized last year, a growing stock market, and steady accumulation of wealth by the middle class. Full implementation of pension reform and its large pool of assets may boost significantly growth of this asset class. Over the past year, returns on mutual funds have outperformed either of the major alternative investments of bank deposits or mattress savings. In 2001, the net asset value (NAV) of all funds was R9.05 billion, compared to 2000 NAV of R4.97 billion. Also in 2001, 14 new UIFs and 14 asset management companies were created. By July 2002 NAVs increased 22% from 2001, despite the 10% decrease in the stock market in June. Currently there are a total of 56 funds in Russia with a total net asset value of R10.7 billion (\$340 million). This week we look more closely at the development of this market, and the problems and prospects for future expansion.

Background

The mutual fund industry in Russia began in 1996, when a Presidential decree established general provisions for unit investment funds (UIFs). Initially UIFs were only allowed to purchase state debt papers (GKO), meaning that UIFs were simply another means to attract resources to finance the federal budget. Not surprisingly, the funds grew rapidly in 1996 and 1997 before the GKO asset bubble burst in 1998. After that, the restriction that funds hold only government-issued securities was waived, allowing UIFs to invest in stocks as well as bonds, and they began to mirror their western counterparts more closely. Equity investments then became the primary assets of UIFs, and by the end of 1999, the mutual funds sector in Russia had shaken off the vestiges of the financial crisis and entered a period of small, albeit steady, growth. Net asset values in the funds doubled between 2000 and 2001, from R4.97 billion to R9.05 billion, reflecting Russia's strong GDP growth.

In 2001, the long-awaited law on Investment Funds was adopted, which provided a firm legal basis for many of the practices set forth in the 1996 decree, such as mandatory disclosure rules on price, registration of prospectuses, licensing of managers and minimum capital requirements. The law also included new provisions to allow for the trading of funds on the secondary market and development of closed-end investment funds. However, the law required regulations covering mutual funds to be worked out by the Federal Commission of Securities Markets (FCSM) and the executive branch. These regulations will establish operating procedures within the industry, as well as the rights and obligations of asset management companies. The FCSM management believes that, although it is taken a long time to complete these regulations, it is important to set the proper ground rules in order increase public trust in these assets. In addition, the tax regime for UIFs is now clarified, and other key legislation, such as the amendments to the law on Securities (projected for 2002), and the law on Insider Trading (awaiting a second Duma reading) will provide additional support for mutual funds. With total capitalization of the stock market expected to reach \$91 billion in 2002, and further increase to \$147

billion in 2003, as well as growth of the corporate bond markets, the FCSM believes the potential is there to grow the mutual fund market 10 times over.

Market Trends

Given these positive trends, growth of mutual funds has continued into 2002. In the first half of 2002, the net asset value of all funds was up at R1 billion, an increase of 22 percent from 2001, with all funds reporting profits despite a downturn in the stock market in June. Over the past year, UIF yields have significantly outperformed alternative investments (relative to risk), such as bank deposits. For example, mutual funds specializing in bonds gained 30-40%, while diversified funds (in terms of investment tools) were up by 15-77% (open) and 19-230% (interval). Stock mutual funds showed 27-122% growth. Another trend to note is the continued diversification of investments within funds. Beginning in mid-2001, market conditions led fund managers to favor corporate bonds, both by diversifying existing funds into these instruments and creating new funds concentrating on them. The first corporate bond included into a mutual fund portfolio was Slavneft in June 2001. This trend has continued into 2002, given the higher liquidity of commercial paper compared to other bonds, a good combination of yield and duration, as well as improved company financial data. In addition, in mid 2002 the Central Bank issued a regulation allowing some asset management companies to include Russian securities denominated in foreign currency, such as Eurobonds, which will also help diversify the funds.

Currently there are six major players in asset management: Troika, Prio Global, Regiongazfinance, DIT, and Templeton (recently sold to United Financial Group), which manage approximately 96% of the mutual fund assets. Prio Global is bullish on the prospects for potential growth of mutual funds due to the undervalued stock market. As corporate governance improves and companies become more transparent, the riskiness of these stocks will decline and prices will rise. In their view, new investment opportunities are bright, given diversification among financial-industrial groups into new business, such as the trend of oil and gas firms investing in electricity generation. The IT and telecoms sector also show promise for investment. In addition, more money is becoming available for investment, with the possibilities of pension fund investments into mutual funds, as well as private investment capital seeking higher returns.

In anticipation of completion of the new FCSM regulations and increased market prospects, over the past year asset managers have created new infrastructure to support mutual funds. Because asset management companies do not have a banking license and cannot collect deposits, special custodian accounts have been created with several Russian banks to service asset management companies. Some companies have also established call centers, investor walk-in centers, internet and agent based distribution to help service the growing number of individual customers.

However, the overall size of the market remains very small relative to the investing population. Approximately \$500 million has been invested in mutual funds, a small fraction of the total savings the Russians hold, which is estimated to be between \$20

billion to \$200 billion. Most of the money invested in mutual funds to date originate from the corporate sector. With increased incomes over the past year, however, individual investments have been growing. For example, Pio Global claims they are raising \$1 million to \$1.5 million per month in the first half of 2002 from individual walk-in customers.

Barriers to Growth

Despite the progress made to date, industry participants cite the continued difficulties, barriers, and other problems that are impeding development of the sector. These barriers fall generally into three categories: legal, structural, and educational. The legal issues, though individually small, add up to a significant problem. For example, conflicts between the law on Securities and the law on Pension Funds essentially prevent pension fund money from investing in mutual funds. The securities law states, sensibly, that money managers are not allowed to guarantee any returns, but the pension law says that funds may only be invested in instruments with guaranteed returns. Another example is that mutual funds are currently prohibited from taking part directly in primary issues of IPOs. Another issue affecting certain types of funds is one of tax. While UIFs consisting of stocks and bonds do not pay tax on profits, dividends or unrealized capital gains, a UIF consisting of real estate or precious metals or other tangible property must be taxed VAT. The problem is that tax rules specify that legal entities can pay VAT, but mutual funds are not legal entities. Asset managers are therefore awaiting guidance from the tax authorities before developing mutual funds based on assets other than stocks or bonds. A related issue for these types of funds is registration of property titles: again, the UIF is not a legal entity that can fulfill any obligations related to the property contained in a mutual fund. Companies continue to devote a great deal of time and resources trying to resolve such problems; for example, one asset management company said that it pressed the Central Bank for three years before the CBR changed its regulations to allow for the investment into Russian securities denominated in foreign currency. An environment in which mutual funds can develop free of legal constraint or ambiguity will require a continued organized lobbying effort from market participants.

A main structural impediment to distribution and development of mutual funds, especially in the regions, is the lack of banking reform. Russia's inefficient banking system inhibits transfer of funds around the country: with a typical fund earning between 15-20%, a wire transfer fee of 4% to and from the regions cuts significantly into returns. As most of Russia's asset management expertise is in Moscow, this represents a real barrier that inhibits the broader pool of regional money from investing in mutual funds. Another problem is that asset management companies cannot collect deposits, so they must open custodial accounts with Russian banks, adding another layer of costs. Another issue has to do with management companies fees. Currently the volume of non-state pension money received by asset management companies is so small, it does not make sense for them to divert them to mutual funds, because that would add an extra layer of fees: instead, it simply allocates them among its existing investment instruments within the company. Over time, as volumes of investments grow, both from the non-state

pension fund and the government managed portion, and the stock market becomes more diversified, this barrier should become less significant.

Finally, the funds face an educational hurdle, especially as concerns individual investors. Currently only a small portion of the Russian population -- mainly the emerging middle and professional classes -- has both the necessary savings and financial sophistication to invest in mutual funds. This small but growing middle class, both in Moscow and in the regions, will be very important to the mass adoption of mutual funds in Russia, and they will need to understand and be educated about mutual funds. Many potential mutual fund investors are unaware of the existence of mutual funds, or that the primary purpose is to diversify investment risk. Many of the best candidates to invest in mutual funds currently choose to keep their savings either in dollar-denominated accounts or longer-term ruble deposits in Sberbank. Asset managers believe that a sustained education campaign over the course of a year or so, consisting of television ads, seminars, talk show appearances, and the like, could raise awareness of the advantages of mutual funds. Pfo Global launched a successful ad campaign, including television ads, that has boosted its assets from \$7 million to \$12 million between February and May 2002. The FCSM also has a public outreach campaign and has held seminars in the regions to raise awareness about mutual funds. However, widespread distrust of banks and other financial institutions in Russia will continue to be a barrier until more concrete steps are taken to reform the banking sector. In addition, investors will have to understand that mutual funds are more risky than bank deposits or bonds and that returns cannot be guaranteed. Indeed, the mutual fund market developed quickly based on rising stock market returns, but has not yet been tested during a sustained market downturn. During the brief drop of the RTS during the past summer, investments into mutual funds slowed, and some investors chose to withdraw their money, but the market was not fundamentally affected.

Conclusion

Mutual funds have the potential to become a significant part of the asset management landscape in Russia, but it will take several more years before they can take root among average, middle class investors that make up much of mutual funds' investment base in the U.S. and Europe. The trend toward returns-based investing and efficient use of capital are encouraging, but these developments can only go so far until there is increased trust in the banking system and improved diversification and liquidity in capital markets. Continued reform in the banking sector and economic growth should provide increased market confidence. New mutual fund investors will also add to the chorus of minority investors who demand better corporate governance to increase their earnings, and better regulation and legislation to support development of a larger variety of investment vehicles.